



Bonus Depreciation, Section 179 Expense and Maine Income Tax

**Instructions for Calculating the Modifications to Maine Income Due
to the State's Decoupling from Federal Tax Law Changes**

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DRAFT AS OF OCTOBER 22, 2004
SUBJECT TO CHANGE

I

SUMMARY OF MAINE'S TREATMENT OF BONUS DEPRECIATION AND SECTION 179 EXPENSING

Background

The federal Job Creation and Worker Assistance Act ("JCWAA") of 2002 enacted a "bonus depreciation" for MACRS property acquired after September 10, 2001 and before September 11, 2004 (and placed in service prior to January 1, 2005 in most cases). This bonus depreciation was an additional 30% deduction allowable in the first year. The bonus depreciation was to be calculated on the adjusted basis after any section 179 expense claimed and further reduced the depreciable basis to be used for the remaining life of the property.

The Jobs and Growth Tax Relief Reconciliation Act ("JGTRRA") of 2003 expanded the first-year bonus depreciation to 50% for property acquired after May 5, 2003 and prior to January 1, 2005 and placed in service prior to January 1, 2005 (January 1, 2006 for certain property). All property meeting the above date restrictions as well as the 30% bonus depreciation criteria also qualifies for the 50% bonus depreciation. Taxpayers may elect not to apply bonus depreciation and, for property eligible for the 50% bonus depreciation, may choose to apply the 30% bonus depreciation instead.

JGTRRA also increased the IRC section 179 expense limit from \$25,000 to \$100,000 for property placed in service in tax years beginning after 2002 and before 2006. In addition, JGTRRA increased the phase-out threshold during this time from \$200,000 of qualifying property to \$400,000 of qualifying property and included certain off-the-shelf computer software in the list of qualifying property.

Maine's Legislative response

With respect to 2001 qualified property, Maine is in full conformity with federal bonus depreciation law. However, to prevent a substantial revenue loss with respect to 2002 and following years, Maine has decoupled from federal bonus depreciation and (for 2003 and after) the increases in section 179 expense limitations (including increases in the phaseout threshold). An approach was developed to reverse the effect of the federal increase in first-year depreciation without forcing business owners to maintain two depreciation schedules for each qualifying piece of property. Following is a description of the state law with examples. See page 12 for additional examples.

Maine Law

Maine law has two parts: the first part is an addition modification representing a reversal of the federal bonus depreciation law and section 179 increases; the second part is a recapture of that addition modification through subtraction modifications throughout the remaining life of the asset. **By tying the subtraction modifications, or recapture, directly to the addition modification, federal depreciation remains intact and does not need to be adjusted at the state level. In other words, there is no separate Maine depreciation schedule for affected taxpayers.**

To determine the addition modification, the allowable depreciation and section 179 expense under federal law prior to JCWAA and JGTRRA is subtracted from the depreciation and section 179

expense actually calculated and used for federal purposes. For property placed in service in 2003, 2004 or 2005, five percent of the addition modification is recaptured in the year following the year the property is placed in service, and the remaining ninety-five percent is recaptured evenly throughout the remainder of the asset's life, beginning in year 3. For assets placed in service in 2002, there is no subtraction modification in 2003; the addition modification is recaptured evenly throughout the remainder of the asset's life beginning with the 2004 tax year (3-year property placed in service in 2002 is recaptured entirely in 2004).

Example (30% bonus depreciation):

In 2002, a taxpayer purchases and places in service a 5-year MACRS asset worth \$100,000. The taxpayer opts for the first-year 30% bonus depreciation. The federal depreciation schedule, using half-year convention, looks like this:

Year 1 (2002)	
Bonus Depreciation	
(\$100,000 x 30%)	\$30,000
Adjusted Basis of Asset	
(100,000 - 30,000 bonus depreciation)	
= \$70,000	
MACRS Depreciation	
(((\$100,000 - \$30,000) x 20%)	<u>\$14,000</u>
Total Depreciation, Year 1 (2002)	\$44,000

Depreciation, Year 2 (2003)	
(\$70,000 x 32%)	22,400
Depreciation, Year 3 (2004)	
(\$70,000 x 19.2%)	13,440
Depreciation, Year 4 (2005)	
(\$70,000 x 11.52%)	8,064
Depreciation, Year 5 (2006)	
(\$70,000 x 11.52%)	8,064
Depreciation, Year 6 (2007)	
(\$70,000 x 5.76%)	<u>4,032</u>
	<u>\$100,000</u>

Although Maine adjusts for the bonus depreciation in the year the property is placed in service, it otherwise follows the federal depreciation schedule. To calculate the adjustment for the additional first-year depreciation claimed at the federal level, Maine requires that the taxpayer first determine the amount of first-year depreciation that would have been allowable had JCWAA and JGTRRA never been passed. Namely, first-year depreciation would have been (\$100,000 x 20%) = \$20,000. Because \$44,000 was actually used at the federal level, the first-year Maine addition modification would be \$24,000 (\$44,000 - \$20,000). Note: this addition amount must not be used to adjust the depreciable basis of the asset; Maine does not require the taxpayer to maintain separate depreciation schedules. The depreciation schedule above is used for both federal and Maine purposes, but Maine also has income adjustments illustrated as follows:

2002 add-back	
(\$44,000 - \$20,000)	\$24,000
Less: 2003 recapture	
(there is no year 2 recapture for 2002 assets)	
2004 recapture	
(\$24,000/3)	(8,000)
2005 recapture	
(\$24,000/3)	(8,000)
2006 recapture	
(\$24,000/3)	(<u>8,000</u>)
	\$ 0

For assets placed in service beginning on or after January 1, 2003, the Maine addition modification consists of two segments: 1) bonus depreciation and 2) section 179 expense. Any amount of bonus depreciation claimed and used in the taxable year on federal Form 4562 will trigger a Maine addition modification. However, with respect to section 179 expense, only amounts in excess of \$25,000 will require an add-back. The following example illustrates the calculation for the Maine add-back due to a federal election for both section 179 expense and bonus depreciation in tax year 2003.

Example (§ 179 expense and 50% bonus depreciation):

Asset basis = \$150,000 (5-year property)

§ 179 claimed at federal level = \$100,000

50% Bonus Depreciation =
 $(150,000 - 100,000) \times 50\% = \$25,000$

Adjusted Basis of Asset
 $150,000 - 100,000 - 25,000 = \$25,000$

First-year MACRS Depreciation
 $25,000 \times 20\% = \$5,000$

Total Federal Expense/Depreciation =
 $100,000 + 25,000 + 5,000 = \$130,000$

Maine Recalculation of Allowable Expense/
Depreciation under Prior Federal Law:

§ 179 expense allowed = \$25,000

Adjusted Basis of Asset
 $150,000 - 25,000 = \$125,000$

First-year MACRS Depreciation
 $125,000 \times 20\% = \$25,000$

Total Prior Federal Law Expense/Depreciation =
 $25,000 + 25,000 = \$50,000$

Maine Addition Modification, Year 1 =
 $130,000 - 50,000 = \$80,000$

Subtraction Modifications:

Year 2 = $80,000 \times 5\% = \$4,000$

Year 3 = $(80,000 - 4,000)/3 = \$25,334$

Year 4 = $76,000/3 = \$25,333$

Year 5 = $76,000/3 = \$25,333$

Total Subtraction Modifications = \$80,000

If a taxpayer is limited in the amount of section 179 expense that may be used, due to business income limitations, the carryover amount is disregarded for purposes of calculating the Maine income modifications.

II

GENERAL INSTRUCTIONS FOR FORMS 1040ME AND 1120ME INCOME MODIFICATION LINES

Addition modification

The Maine addition modification (add-back) is the *net difference* between the higher federal depreciation and section 179 expense deduction amounts now allowed under the Job Creation and Worker Assistance Act (JCWAA) of 2002 and the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003 and the amount of depreciation and section 179 expense that would have otherwise been allowed prior to the enactment of those laws. **The addition modification does not cause the creation of a separate depreciation schedule for Maine, nor does it alter the calculated gain on the sale of an asset. Disposal of an asset does not change the recapture schedule. Further, a loss in a year in which a recapture subtraction modification would have been claimed does not create a carryover of that subtraction modification. Also, the addition modification does not apply to affected property placed in service in 2001.**

Recapture

The addition modification is recaptured in future years, depending on the class-life of the related asset. For assets placed in service in 2003 - 2005, 5% of the addition modification is recaptured in Year 2, with the remaining amount recaptured in equal yearly installments over the remaining class-life of the asset, beginning in Year 3. For example, if an addition modification of \$12,000 relates to 5-year property, \$600 is recaptured in Year 2, and \$3,800 is recaptured in each of Years 3, 4 and 5. The same rules apply to assets placed in service in 2002, except that recapture begins in Year 3 and is spread out *evenly* over the remaining life of the asset. For example, if an addition modification of \$12,000 relating to five-year property was made

in 2002, the recapture amounts would be \$4,000 in each of years 3, 4 & 5.

Disposal of property

Disposal of property does not change the recapture period. For example, a five-year asset is purchased in 2003 and a bonus depreciation/§ 179 addition modification is required for Maine tax purposes. The recapture for this addition modification is spread out over four years, 2004 - 2007. The asset is then sold in 2005. The outstanding addition modification is not fully recaptured in that year; recapture is still spread out over the initial four-year schedule. Gain or loss on disposition of an asset for Maine purposes is the same as it is for federal purposes.

Fiscal-year filers

The addition modification relates to “property placed in service during the taxable year.” A tax year ending 9/30/03, therefore, would be governed by the recapture schedule applying to taxable years beginning in 2002 (even though some assets may have been purchased and placed in service in calendar year 2003), meaning there would be no 5% recapture in year 2 (*see example #4 on page 14*).

Federal depreciation changes other than those contained in JCWAA or JGTRRA

Maine’s nonconformity regarding bonus depreciation and section 179 expensing is limited to the increases enacted by section 101 of JCWAA of 2002 and sections 201 and 202 of JGTRRA of 2003. Maine conforms to all other bonus depreciation/§ 179 changes not part of JCWAA or JGTRRA.

Federal business income limitation

At the federal level, a taxpayer can use section 179 expense only to reduce business income. The taxpayer can claim an overall total, however, up to \$100,000 in expense. If business income is lower than the allowable section 179 claim, the remainder is carried over to future year(s).

Note: Reference to “business income” in this guidance document means, for pass-through entities, taxable income from trade or business activity determined in accordance with Treas. Reg. 1.179-2 (C)(2) & (3).

Maine’s addition modification related to the increased levels of section 179 expensing (36 MRSA §§ 5122 (1)(N)(3) and 5200-A (1)(N)(3)) pertains only to the net increase in section 179 expense related to **property placed in service that year**. As a result, carryover amounts from previous years entered on federal Form 4562 would not enter into the calculation of the addition modification.

Example #1:

Company A purchases a 5-year asset for \$100,000 in 2003 and decides to apply section 179 expense to the whole amount. However, the company has only \$30,000 of business income that year, so \$30,000 of expense is applied to 2003 and the remaining \$70,000 is carried over to 2004.

The Maine add-back is based, not on the total \$100,000 claimed by Company A, but on the \$30,000 actually used in the year the asset was placed in service.

Under prior federal law, which Maine is following, \$25,000 of the asset would be expensed under section 179, while the remaining \$75,000 would be depreciated. The total amount of expense and depreciation allowed would be $\$25,000 + (\$75,000 \times 20\% \text{ 1st year depreciation}) = \$25,000 + \$15,000 = \$40,000$. Since the amount allowable under the

old law is higher than the amount actually used in 2003, no addition modification is necessary.

The allocation of the recapture amounts must be made based on the class-life of the assets. In the example above, since there was no addition modification, there will be no recapture.

Example #2:

In 2003, Company A purchases a 5-year asset for \$50,000 and a 7-year asset for \$50,000. Company A decides to apply section 179 expense to the whole amount. However, the company has only \$60,000 of business income that year, so \$60,000 of expense is applied to 2003 and the remaining \$40,000 is carried over to 2004.

Under prior federal law, which Maine is following, \$25,000 of the assets would be expensed under section 179, while the remaining \$75,000 would be depreciated. The \$75,000 is apportioned between the 5-year asset and the 7-year asset based on the total original basis. In this case, since each asset cost the same, 50% of the disallowed section 179 expense would be associated with the 5-year property and 50% with the 7-year property.

Therefore, the total amount of expense and depreciation allowed would be $\$25,000 + ((\$75,000/2) \times 20\% \text{ 1st year depreciation} + (\$75,000/2) \times 14.29\% \text{ 1st year depreciation}) = \$37,859$. The addition modification is the difference between what was actually used and would have been used under prior law: $\$60,000 - \$37,859 = \$22,141$.

The allocation of the recapture amounts must be separated between the asset classes. Company A would, therefore, recapture $(60,000 \times 50\%) - [(25,000 \times 50\%) + (75,000 \times 50\%) \times 0.2] = 30,000 - (12,500 + 7,500) = \$10,000$ over years 2 through 5 and $30,000 - [12,500 + (37,500 \times 0.1429)] = 30,000 - 17,859 = \$12,141$ over years 2 through 7.

The addition modification associated with the increase in section 179 expense should apply only to the amount of section 179 expense claimed and deducted in the taxable year. Carryover amounts should be ignored for purposes of the calculation. The modification would be calculated based on the difference between the federal amount deducted and the amount allowed by Maine.

In future years, federal carryover amounts are not used in calculating any addition modification for Maine purposes. The addition modification relates to § 179 expense used in the year the asset is placed in service (*see* example #5 on page 15 and example #6 on page 16).

Listed automobiles

Bonus depreciation for listed automobiles is normally treated the same as other bonus depreciation. The one exception is for employee business expenses reported on Form 2106 and claimed as an itemized deduction. Because of its complexity, do not, in this case, calculate an add-back on any bonus depreciation claimed on Form 2106.

Allocation of add-back among affected property

For recapture of the add-back modification, taxpayers must allocate the add-back among the class lives of the affected property. If the Maine add-back relates to property falling into various class lives, the taxpayer must prorate the add-back to the various class lives and recover the add-back amount accordingly. For example, if the Maine add-back for 2003 is \$50,000, 25% of which relates to 5-year property and 75% of which relates to 3-year property, the recovery of the add-back would be determined as follows:

Note: For property placed in service in 2003 or later, the recovery period begins the year following the year the property is placed in service. Thus, the 1st year in the recovery period is actually the 2nd year in the class life of the property. For property placed in service in 2002, the recovery

period begins the 3rd year of the class life of the asset (2004).

5-year property, 1st year in recovery period:
 $(\$50,000 \times 25\%) \times 5\% = \625

3-year property, 1st year in recovery period:
 $(\$50,000 \times 75\%) \times 5\% = \$1,875$

Total 1st year (2004) recovery: \$2,500.

5-year property, 2nd year in recovery period (2005): $[(\$50,000 \times 25\%) - \$625] / 3 = \$3,958$. Note: This is the same amount that the taxpayer would recover in each of the 3rd and 4th years of the recovery period [4th and 5th years in the class life of the property – 2006 and 2007]. The \$625 represents the amount already recovered in the previous tax year and the 3 represents the number of years remaining in the life of the property (1st year is the year in which the property was placed in service and the 2nd year is the year in which \$625 of the add-back was recovered, leaving 3 years in the life of the property).

3-year property, 2nd year in recovery period (2005): $[(\$50,000 \times 75\%) - \$1,875] / 1 = \$35,625$. The \$1,875 represents the amount already recovered in the previous tax year and the 1 represents the number of years remaining in the life of the property (1st year is the year in which the property was placed in service and the 2nd year is the year in which \$1,875 of the add-back was recovered, leaving 1 year in the life of the property).

Total recovery in the 2nd year of the recovery period: \$39,583 (*see* additional example #7 on page 16).

Multistate Businesses

Businesses that are taxable to Maine as well as at least one other state must also calculate a Maine addition modification. The addition modification is based on all of the business' new assets, regardless of where those assets are located. Likewise, the recapture modifications are based on the entire

addition modification (*see* example #11 on page 24).

Pass-through entities

The \$25,000 limitation for § 179 expense is applied to both the entity level as well as the individual taxpayer level. The Maine addition modification for section 179 expense is calculated at the entity level and limitations are also applied at the entity level. In the scenario below, the addition modification would not be further limited at the taxpayer level due to income.

The Maine addition modifications under 36 MRSA §§ 5122 (1)(N) and 5200-A (1)(N) apply “with respect to property placed in service during the taxable year” and relate to “the increase in aggregate cost claimed.” Thus, the limitation is based on the property in question, rather than the individual owners of that property.

The limitation applies to the entity level, meaning that the pass-through entity is limited to \$25,000 in section 179 expense. Each member of a pass-through entity would then be limited to his or her share of the total entity limitation and, therefore, his or her share of the addition and subtraction modifications. For an example showing modifications for a member of several pass-through entities, see examples #8 and #9, starting on page 17.

Passive activity loss

If a taxpayer is a member of a pass-through entity that claims § 179 expense or bonus depreciation and also has a loss for the year, the taxpayer limits the Maine addition modification by the same ratio that the federal loss is limited due to passive activity loss rules. If, for federal purposes, a taxpayer may not use a loss from a pass-through entity at all, the Maine addition modification for section 179 or bonus depreciation would not apply.

If a portion of the loss can be used in the tax year of the loss, the taxpayer would pro rate the addition

modification according to the percentage of the loss that is used (*see* example #10 on page 23).

Resident member of an out-of-state pass-through entity

For a Maine resident member of a pass-through entity domiciled in another state, 100% of the member’s share of the addition modification for bonus depreciation and section 179 expense is added to income. Consequently, 100% of the recapture of the addition modification is allowed for the resident member.

The addition modification is calculated under Maine law and would apply to any member of a pass-through entity claiming bonus depreciation and/or increased section 179 expense.

Nonresident member of a Maine pass-through entity

For a nonresident member of a Maine pass-through entity, the addition modification applies. Therefore, 100% of the net effect of the member’s share of bonus depreciation and § 179 expense is added back to income for purposes of determining Maine income tax.

Member of several pass-through entities

Section 179 of the Code allows taxpayers to elect to expense the cost of up to \$100,000 (for tax years after 2002 and prior to 2006) of certain tangible personal property, subject to reduction for each dollar in excess of \$400,000 of such property placed in service during the year and limited to the taxpayer’s trade or business income for the year (trade or business income prior to the application of section 179 expense).

For members of pass-through entities, these thresholds are applied at both the entity level and the individual member level. At the member level, these thresholds are applied against that member’s aggregate amounts of expense, cost and business income from all pass-through entities.

Amounts disallowed because of the trade or business income limit may be carried forward indefinitely. The carryforward is at the entity level if the entity's trade or business income limits the deduction and is at the individual level if the individual's trade or business income limits the deduction.

At the individual member level, aggregate amounts of section 179 expense in excess of \$100,000 are disallowed at both the federal and state levels. The disallowed amounts are lost and not available for carryover. For Maine purposes, aggregate amounts in excess of \$25,000 (but not more than \$100,000) for a member of several pass-through entities must

be added back to income as an addition modification. Maine law allows for the recapture of these Maine income modifications over the class life of each applicable asset. See example #9 on page 19 for a description of the application of these limitations.

Mergers

If an entity that has previously claimed an addition modification is subsequently merged with another entity or entities, the recapture schedule from the original entity survives the merger and may be claimed as originally scheduled.

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III

FREQUENTLY ASKED QUESTIONS

Following is a list of the most frequently asked questions regarding Maine's decoupling from the changes in federal depreciation/expense law.

Q#1: As a result of decoupling, will Maine have a separate depreciation schedule from federal?

A: No, there is no separate Maine depreciation schedule created as a result of the add-back requirement. Maine follows the federal depreciation schedule on all assets. There has been some confusion related to the fact that Maine asks the taxpayer to complete a pro forma Form 4562 in order to calculate the first year addition modification. However, the calculation for the Maine modification simply reverses the effect of the federal bonus depreciation and increase in section 179 expense on regular depreciation. The addition modification is recaptured by the taxpayer through subtractions to income in later years. Since the addition modification equals the total of the subtraction modifications, no other adjustment is necessary.

Q#2: Can I claim the entire remaining recapture amount if I dispose of the property before the end of its depreciable life?

A: No. The law requires that the recapture amounts, or subtraction modifications, be spread out over the life of the asset. There is no provision that allows full recapture in the year of disposal.

Q#3: Since I can claim \$100,000 in section 179 expense at the federal level, but Maine only allows \$25,000, am I allowed depreciation on the difference?

A: Yes. The first year depreciation that would have been allowed under previous federal law can be used in the calculation of the Maine addition modification. Although you must reverse the effects of the federal bonus depreciation and increases in section 179 thresholds in the year the property is placed in service, this does not create a separate basis for Maine purposes. Rather than creating a separate Maine depreciation schedule, Maine simply allows the first year addition modification to be recaptured over the remaining life of the asset.

Q#4: What if the amount of section 179 expense I use for federal purposes in the first year is limited due to business income?

A: The Maine addition modification is based on the amount of federal depreciation and section 179 expense claimed and used in the year the asset is placed in service. Therefore, any carryover to future years for federal purposes is not included in the addition modification calculation. For example:

Company A purchases a 5-year asset for \$100,000 in 2003 and decides to apply section 179 expense to the whole amount. However, the company has only \$70,000 of business income that year, so \$70,000 of expense is applied to 2003 and the remaining \$30,000 is carried over to 2004.

Under prior federal law, which Maine is following for purposes of the add-back, \$25,000 of the asset would be expensed under section 179, while the remaining \$75,000 would, for 2003, be subject to depreciation. The total amount of expense and depreciation

for 2003 would be $\$25,000 + (\$75,000 \times 20\% \text{ 1st year depreciation}) = 25,000 + 15,000 = \$40,000$.

The add-back for Maine purposes is $70,000 - 40,000 = \$30,000$.

Q: What happens if I calculate a negative addition modification?

A: You will make no adjustment at all. In some circumstances, the amount of pro forma depreciation/expense calculated for Maine purposes is larger than the amount actually used that year at the federal level. If this is the case, no addition modification is required. For example:

Company A purchases a 5-year asset for \$100,000 in 2003 and decides to apply section 179 expense to the whole amount. However, the company has only \$30,000 of business income that year, so \$30,000 of expense is applied to 2003 and the remaining \$70,000 is carried over to 2004.

Under prior federal law, which Maine is following for purposes of the add-back,

\$25,000 of the asset would be expensed under section 179, while the remaining \$75,000 would, for 2003, be subject to depreciation. The total pro forma amount of expense and depreciation for 2003 would be $\$25,000 + (\$75,000 \times 20\% \text{ 1st year depreciation}) = 25,000 + 15,000 = \$40,000$. Since this amount is higher than the amount actually used for federal purposes, no addition modification is necessary.

In 2004, the \$70,000 carryover amount on federal Form 4562 would not require an addition modification on the Maine return, since that amount does not relate to any property placed in service during the taxable year.

Q: What happens to the outstanding recapture amounts if my business moves out-of-state and I am no longer required to file a Maine income tax return?

A: As with the net operating loss recovery modification under 36 MRSA §§ 5122 (2)(H) and 5200-A (2)(H) or with all Maine credit carryover amounts, the bonus depreciation/§ 179 expense recapture modification will be lost if this situation occurs.

IV

ADDITIONAL EXAMPLES

For the following example, assume that the 30% bonus depreciation option is selected and that no additional section 179 expensing is involved.

EXAMPLE #1 – property placed in service in 2003:

Federal return:

Asset purchase price = \$10,000 5-year life

Bonus depreciation = $10,000 \times 30\% = \$3,000$

MACRS depreciation = $(10,000 - 3,000) \times 20\% = \$1,400$

Depreciation with bonus = $3,000 + 1,400 = \$4,400$

Maine return:

MACRS depreciation = $10,000 \times 20\% = \$2,000$

Addition modification: Year 1 = $4,400 - 2,000 = \$2,400$

Recovery: Year 2 = $2,400 \times 5\% = (\$ 120)$

Year 3 = $(2,400 - 120)/3 = (\$ 760)$

Year 4 = “ $(\$ 760)$

Year 5 = “ $(\$ 760)$

For the following example, assume that the taxpayer selected section 179 expense, but no bonus depreciation.

EXAMPLE #2 – property placed in service in 2003:

Federal return:

Asset purchase price = \$110,000 5-year life

Section 179 expense claimed = \$100,000

MACRS depreciation = $(110,000 - 100,000) \times 20\% = \$2,000$

Depreciation with § 179 = $100,000 + 2,000 = \$102,000$

Maine return:

Allowable § 179 = \$25,000

MACRS depreciation = $(110,000 - 25,000) \times 20\% = \$17,000$

Depreciation with § 179 = $25,000 + 17,000 = \$42,000$

Addition modification: Year 1 = $102,000 - 42,000 = \$60,000$

Recovery: Year 2 = $60,000 \times 5\% = (\$ 3,000)$

Year 3 = $(60,000 - 3,000)/3 = (\$19,000)$

Year 4 = “ $(\$19,000)$

Year 5 = “ $(\$19,000)$

For the following example, the taxpayer elected to use both section 179 expense and 50% bonus depreciation.

EXAMPLE #3 – property placed in service in 2003:

Federal return:

Asset purchase price = \$110,000 5-year life

Section 179 expense claimed = \$100,000

Bonus depreciation = $(110,000 - 100,000) \times 50\% = \$5,000$

MACRS depreciation = $(110,000 - 100,000 - 5,000) \times 20\% = \$1,000$

Depreciation with § 179 = $100,000 + 5,000 + 1,000 = \$106,000$

Maine return:

Allowable § 179 = \$25,000

MACRS depreciation = $(110,000 - 25,000) \times 20\% = \$17,000$

Depreciation with § 179 = $25,000 + 17,000 = \$42,000$

Addition modification: Year 1 = $106,000 - 42,000 = \$64,000$

Recovery: Year 2 = $64,000 \times 5\% = (\$ 3,200)$

Year 3 = $(64,000 - 3,200)/3 = (\$20,267)$

Year 4 = “ $(\$20,267)$

Year 5 = “ $(\$20,266)$

EXAMPLE #4 – FISCAL-YEAR FILER (Tax year 7/1/02 - 6/30/03):

Federal return:

Asset #1 purchase price = \$20,000 5-year life, purchased/placed in service 10/02

30% bonus depreciation = $20,000 \times 30\% = \$6,000$

MACRS depreciation = $(20,000 - 6,000) \times 20\% = \$2,800$

Asset #2 purchase price = \$20,000 5-year life, purchased/placed in service 5/03

Section 179 expense = \$20,000

Total depreciation/expense = $6,000 + 2,800 + 20,000 = \$28,800$

Maine return:

Allowable MACRS, Asset #1 = $20,000 \times 20\% = \$4,000$

Allowable § 179, Asset #2 = $\$20,000$

Depreciation with § 179 = $4,000 + 20,000 = \$24,000$

Addition modification: Year 1 = $28,800 - 24,000 = \$4,800$

Recovery: Year 2 = $\$0$ (for property placed in service during tax years beginning in 2002, there is no recapture amount in Year 2)

Year 3 = $4,800/3 = (\$1,600)$

Year 4 = “ $(\$1,600)$

Year 5 = “ $(\$1,600)$

EXAMPLE #5 – BUSINESS INCOME LIMITATION:

Note: This limitation applies to section 179 expense, and not to bonus depreciation

Example using section 179 expense only

Federal return:

Asset purchase price = $\$100,000$ 5-year life

Section 179 expense = $\$100,000$

Business income = $\$30,000$

The amount of section 179 expense that the taxpayer can use this year is limited to $\$30,000$. The additional $\$70,000$ of section 179 expense is carried over to the following year.

Maine return:

Allowable § 179 = $\$25,000$

MACRS depreciation = $(100,000 - 25,000) \times 20\% = \$15,000$

Depreciation with § 179 = $25,000 + 15,000 = \$40,000$

Addition modification: Year 1 = $30,000 - 40,000 = (\$10,000)^*$

*Since the expense deduction and allowable depreciation under prior law is greater than the amount actually used for this tax year, the taxpayer would have no addition modification and, therefore, no subtraction modifications in subsequent years. The addition modification is based on the increase in depreciation and/or expense used in the taxable year for federal purposes over the Maine pro forma depreciation/expense under prior federal law. Since, in this case, there is no increase, there is also no modification for Maine purposes.

What happens in the following year, when the taxpayer uses the \$70,000 carryforward? There is no modification based on the carryforward amount either. The amount of section 179 expense subject to the Maine addition modification is only the amount used for federal purposes in the same year that the asset is placed in service.

EXAMPLE #6 – BUSINESS INCOME LIMITATION continued – property placed in service in 2003:

Example using section 179 expense and bonus depreciation

Federal return:

Asset purchase price = \$120,000 5-year life

Section 179 expense = \$100,000

50% bonus depreciation = $(120,000 - 100,000) \times 50\% = \$10,000$

MACRS depreciation = $(120,000 - 100,000 - 10,000) \times 20\% = \$2,000$

Total federal deduction/expense = $100,000 + 10,000 + 2,000 = \$112,000$

Business income = \$50,000

Federal depreciation/expense is limited to: $50,000 + 10,000 + 2,000 = \$62,000$

Carryforward to next year = $100,000 - 50,000 = \$50,000$

Maine return:

Allowable § 179 = \$25,000

MACRS depreciation = $(120,000 - 25,000) \times 20\% = \$19,000$

Depreciation with § 179 = $25,000 + 19,000 = \$44,000$

Addition modification: Year 1 = $62,000 - 44,000 = \$18,000$

Recovery: Year 2 = $18,000 \times 5\% = (\$ 900)$

Year 3 = $(18,000 - 900)/3 = (\$ 5,700)$

Year 4 = $(\$ 5,700)$

Year 5 = $(\$ 5,700)$

EXAMPLE #7 – APPLICATION OF SECTION 179 RECAPTURE – property placed in service in 2003:

Federal return:

Asset #1 purchase price = \$70,000 3-year life

Section 179 expense = \$70,000

Asset #2 purchase price = \$30,000 5-year life

Section 179 expense = \$30,000

Total section 179 expense = $70,000 + 30,000 = \$100,000$ (70% related to 3-year property, 30% related to 5-year property)

Maine return:

Allowable § 179 = \$25,000

-related to 3-year asset = $25,000 \times 70\% = \$17,500$

-related to 5-year asset = $25,000 \times 30\% = \$ 7,500$

Allowable MACRS, Asset #1 = $(70,000 - 17,500) \times 33.33\% = \$17,498$

Allowable MACRS, Asset #2 = $(30,000 - 7,500) \times 20\% = \$4,500$

Depreciation with § 179 = $25,000 + 17,498 + 4,500 = \$46,998$

Add-back related to 3-year property = $70,000 - 17,500 - 17,498 = \$35,002$

Add-back related to 5-year property = $30,000 - 7,500 - 4,500 = \$18,000$

Total add-back = $35,002 + 18,000 = \$53,002$

Recovery:

Year 2 = $(35,002 \times 5\%) + (18,000 \times 5\%) = 1,750 + 900 =$ (\$ 2,650)

Year 3 = $(35,002 - 1,750) + (18,000 - 900)/3 = 33,252 + 5,700 =$ (\$38,952)

Year 4 = $(18,000 - 900)/3 =$ (\$ 5,700)

Year 5 = “ (\$ 5,700)

EXAMPLE #8 – MEMBER OF SEVERAL PASS-THROUGH ENTITIES – property placed in service in 2003:

Member A is a part owner of three partnerships. Member A owns 50% of Partnership #1, 20% of Partnership #2 and 75% of Partnership #3

Partnership #1

Federal return:

Asset purchase price = \$10,000 5-year life

No section 179 expense

50% bonus depreciation = $10,000 \times 50\% = \$5,000$

MACRS depreciation = $(10,000 - 5,000) \times 20\% = \$1,000$

Total depreciation = $5,000 + 1,000 = \$6,000$

Maine return:

MACRS depreciation = $10,000 \times 20\% = \$2,000$

Addition modification = $6,000 - 2,000 = \$4,000$

Member A portion of Year 1 addition = $4,000 \times 50\% =$ \$2,000

Recovery: Year 2 = $2,000 \times 5\% =$ (\$ 100)

Year 3 = $(2,000 - 100)/3 =$ (\$ 634)

Year 4 = “ (\$ 633)

Year 5 = “ (\$ 633)

Partnership #2

Federal return:

Asset purchase price = \$50,000 7-year life

Section 179 expense = \$50,000

Maine return:

Allowable § 179 = \$25,000

MACRS depreciation = $(50,000 - 25,000) \times 14.29\% = \$3,573$

Total expense/depreciation = $25,000 + 3,573 = \$28,573$

Addition modification = $50,000 - 28,573 = \$21,427$

Member A portion of Year 1 addition = $21,427 \times 20\% = \$4,285$

Recovery: Year 2 = $4,285 \times 5\% = (\$ 214)$

Year 3 = $(4,285 - 214)/5 = (\$ 815)$

Year 4 = “ $(\$ 814)$

Year 5 = “ $(\$ 814)$

Year 6 = “ $(\$ 814)$

Year 7 = “ $(\$ 814)$

Partnership #3

Federal return:

Asset purchase price = \$30,000 3-year life

No section 179 expense

50% bonus depreciation = $30,000 \times 50\% = \$15,000$

MACRS depreciation = $(30,000 - 15,000) \times 33.33\% = \$5,000$

Total depreciation = $15,000 + 5,000 = \$20,000$

Maine return:

MACRS depreciation = $30,000 \times 33.33\% = \$9,999$

Addition modification = $20,000 - 9,999 = \$10,001$

Member A portion of Year 1 addition = $10,001 \times 75\% = \$7,501$

Recovery: Year 2 = $7,501 \times 5\% = (\$ 375)$

Year 3 = $7,501 - 375 = (\$7,126)$

Member A

Federal return (passed through from partnerships):

Asset purchase price = $10,000 + 50,000 + 30,000 = \$90,000$

Related to 3-year property = $30,000/90,000 = 33.33\%$

Related to 5-year property = $10,000/90,000 = 11.11\%$

Related to 7-year property = $50,000/90,000 = 55.56\%$

Section 179 expense = \$50,000

Maine return:

Section 179 expense = \$25,000

Year 1 addition modifications = $2,000 + 4,285 + 7,501 = \$13,786$

Recovery: Year 2 = $100 + 214 + 375 = (\$ 689)$

Year 3 = $634 + 815 + 7,126 = (\$ 8,575)$

Year 4 = $633 + 814 = (\$ 1,447)$

Year 5 = $633 + 814 = (\$ 1,447)$

Year 6 = $(\$ 814)$

Year 7 = $(\$ 814)$

EXAMPLE #9 – SECTION 179 EXPENSE AND A MEMBER OF SEVERAL PASS-THROUGH ENTITIES – PROPERTY PLACED IN SERVICE IN 2003:

Federal return

Partnership #1:

Business income	\$100,000	x 50%
Section 179 expense	<u>\$ 80,000</u>	
Distributable income	\$ 20,000	

Member A's share:

\$50,000
<u>\$40,000</u>
<u>\$10,000</u>

Member A is a 50% owner of this partnership

Section 179 expense breakdown:

\$20,000 3-year property (25%)
\$60,000 5-year property (75%)

Limitations:

Dollar Limitation:

The aggregate cost of section 179 property that a taxpayer can elect to expense is \$100,000.

Business Income Limitation:

Because the partnership's business income is \$100,000 and the aggregate cost of the section 179 property is \$80,000, there is no business income limitation.

Carryforward:

There is no carryforward amount because there has been no limitation based on taxable income.

Partnership #2:

Business income	\$100,000	x 90%
Section 179 expense	<u>\$ 80,000</u>	
Distributable income	\$ 20,000	

Member A's share:

\$90,000
<u>\$72,000</u>
<u>\$18,000</u>

Member A is a 90% owner of this partnership

Section 179 expense breakdown:

\$50,000 5-year property (62.5%)
\$30,000 7-year property (37.5%)

Limitations: same as for Partnership #1.

Member A:

Business income	50,000 + 90,000	\$140,000
Section 179 expense	40,000 + 72,000 = 112,000 (limited to 100,000)	<u>\$100,000</u>
Federal Adjusted Gross Income ("FAGI")		<u>\$ 40,000</u>

Limitations:

Dollar Limitation:

The aggregate cost of section 179 property that a taxpayer can elect to expense is \$100,000. Since Member A's aggregate expense passed through from the partnerships exceeds \$100,000, the excess is disallowed for both federal and state purposes.

Maine return

Maine Limitation:

Dollar limitation:

The aggregate cost of section 179 property that a taxpayer can elect to expense is \$25,000. The partnership may not allocate to its partners as a section 179 expense deduction for any taxable year more than the partnership's business income limitation for that taxable year. (Treas. Reg. 1.179-2(c)(2)).

Business Income Limitation:

For each partnership, the partnership's business income is \$100,000; therefore, there is no limitation in the \$25,000 allowed in the section 179 expense deduction for Maine purposes.

Carryforward:

There is no carryforward amount because there has been no limitation based on business income.

Since section 179 expense is limited to \$25,000, each partnership must calculate a total addition modification and then allocate it among its members. The addition modification is equal to the difference in the section 179 expense taken at the federal level and the allowable pro forma amount for Maine purposes, net of allowable pro forma first year depreciation.

Partnership #1:

Difference between amount taken for federal purposes and allowable pro forma amount for Maine purposes: $80,000 - 25,000 = \$55,000$

Breakdown: 25% applies to 3-year property; 75% applies to 5-year property

First year depreciation: 33.33% for 3-year property; 20% for 5-year property

Allowable depreciation = $(\$55,000 \times 25\% \times 33.33\%) + (\$55,000 \times 75\% \times 20\%)$

$$= 4,583 + 8,250 = \$12,833$$

$$\text{Total addition modification} = 55,000 - 12,833 = \$42,167$$

$$\text{Addition allocated to Member A} = 42,167 \times 50\% \text{ ownership} = \underline{\$21,084}$$

Partnership #2:

Difference between amount taken for federal purposes and allowable pro forma amount for Maine purposes: $80,000 - 25,000 = \$55,000$

Breakdown: 62.5% applies to 5-year property; 37.5% applies to 7-year property

First year depreciation: 20% for 5-year property; 14.29% for 7-year property

$$\begin{aligned} \text{Allowable depreciation} &= (\$55,000 \times 62.5\% \times 20\%) + (\$55,000 \times 37.5\% \times 14.29\%) \\ &= 6,875 + 2,947 = \$9,822 \end{aligned}$$

$$\text{Total addition modification} = 55,000 - 9,822 = \$45,178$$

$$\text{Addition allocated to Member A} = 45,178 \times 90\% \text{ ownership} = \underline{\$40,660}$$

Member A:

FAGI =	\$ 40,000
Modification from Partnership #1 =	\$ 21,084
Modification from Partnership #2 =	<u>\$ 40,660</u>
	<u>\$101,744</u>

However, this amount needs to be adjusted further, due to the \$25,000 section 179 expense limitation application at the member level. The addition modification that the partnerships calculated effectively reduced the section 179 expense claimed by each to \$25,000. After application of Member A's ownership percentage to each partnership's total section 179 expense allowed by Maine, the result is:

Partnership #1: \$25,000 expense x 50% Member A ownership =	\$12,500
Partnership #2: \$25,000 x 90% ownership =	<u>\$22,500</u>
Effective section 179 expense passed through to Member A =	<u>\$35,000</u>

This total exceeds the \$25,000 allowable aggregate by \$10,000. Therefore, an additional modification of \$10,000 is required. Since, under prior law, this excess aggregate would have simply been disallowed, a regular first year depreciation amount is not allowed on the \$10,000 for purposes of calculating the Maine addition modification.

Finally, the calculation for Maine adjusted gross income ("MAGI") looks like this:

FAGI =	\$ 40,000
Partnership #1 modification =	\$ 21,084
Partnership #2 modification =	\$ 40,660
Excess aggregate modification =	<u>\$ 10,000</u>
MAGI =	<u>\$111,744</u>

Recapture:

For purposes of recapture the following percentages apply:

From Partnership #1: \$20,000 3-year property
\$60,000 5-year property

Member A is a 50% owner of this entity, so his allocated expense breakdown is:

$20,000 \times 50\% = \$10,000$ 3-year property
 $60,000 \times 50\% = \$30,000$ 5-year property

From Partnership #2: \$50,000 5-year property
\$30,000 7-year property

Member A is a 90% owner of this entity, so his allocated expense breakdown is:

$50,000 \times 90\% = \$45,000$ 5-year property
 $30,000 \times 90\% = \$27,000$ 7-year property

Combining the two entities,

$30,000 + 45,000 =$
\$ 10,000 3-year property
\$ 75,000 5-year property
\$ 27,000 7-year property
\$112,000

Percentage allocation: $10,000/112,000 = 8.9\%$ 3-year property
 $75,000/112,000 = 67.0\%$ 5-year property
 $27,000/112,000 = 24.1\%$ 7-year property

The recapture schedule is as follows:

Subtraction modification in Year 2 = $10,000 \times 5\% = \$500$

Remainder to be recaptured = $10,000 - 500 = \$9,500$

Subtraction modification in Year 3 = $(9,500 \times 8.9\%) + [(9,500 \times 67.0\%)/3] + [(9,500 \times 24.1\%)/5] =$
 $846 + (6,365/3) + (2,290/5) = 846 + 2,122 + 458 = \$3,426$

Subtraction modification in Year 4 = $(6,365/3) + (2,290/5) = 2,121 + 458 = \$2,579$

Subtraction modification in Year 5 = $(6,365/3) + (2,290/5) = 2,121 + 458 = \$2,579$

Subtraction modification in Year 6 = $(2,290/5) = \$458$

Subtraction modification in Year 7 = $(2,290/5) = \$458$

These recapture amounts, as calculated by Member A, are in addition to the recapture amounts that each partnership will calculate and pass through to Member A on an annual basis.

EXAMPLE #10 – PASSIVE ACTIVITY LOSS – property placed in service in 2003:

Member A is 50% owner of Partnership #1. Income from Partnership #1 is considered passive activity income for Member A. Member A has no other business income.

Partnership #1

Federal return:

Asset purchase price = \$50,000 5-year life

No section 179 expense

50% bonus depreciation = $50,000 \times 50\% = \$25,000$

MACRS depreciation = $25,000 \times 20\% = \$5,000$

Total depreciation = \$30,000; Member A's share = $30,000 \times 50\% = \$15,000$

2003 passive activity loss = (\$20,000); Member A's share = $(20,000) \times 50\% = (\$10,000)$

Maine return:

MACRS depreciation = $50,000 \times 20\% = \$10,000$

Addition modification = $30,000 - 10,000 = \$20,000$; Member A's share = $20,000 \times 50\% = \$10,000$

Recovery: Year 2 = $20,000 \times 5\% = (\$ 1,000)$; Member A's share = $1,000 \times 50\% = (\$ 500)$
Year 3 = $(20,000 - 1,000)/3 = (\$6,334)$; Member A's share = $(\$ 3,167)$
Year 4 = " $(\$ 6,333)$; Member A's share = $(\$ 3,167)$
Year 5 = " $(\$ 6,333)$; Member A's share = $(\$ 3,166)$

Member A

Share of loss from Partnership #1 = (\$10,000)

Share of passive activity income from other sources = \$3,000

Member A can only use \$3,000, or 30% of the loss from Partnership #1 in the taxable year; therefore, only 30% of the addition modification is required for Maine tax purposes.

Addition: Year 1 = $10,000 \times 30\% = \$3,000$

Recovery: Year 2 = $500 \times 30\% = (\$ 150)$
Year 3 = $3,167 \times 30\% = (\$ 950)$
Year 4 = $3,167 \times 30\% = (\$ 950)$
Year 5 = $3,166 \times 30\% = (\$ 950)$

The amount of passive activity loss from Partnership #1 used by Member A in future years will not generate an addition modification in those years.

EXAMPLE #11 – MULTISTATE BUSINESS – property placed in service in 2003:

Corporation A is located in several different states. Corporation A places \$100,000 of 5-year property in service in 2003, some in Maine, some elsewhere. Corporation A claims the total amount of the property, \$100,000 as a section 179 expense. Corporation A calculates its Maine corporate income tax apportionment factor to be 0.15 (15% of income attributable to Maine). The Maine addition modification for the federal section 179 expense claimed is calculated as follows:

Section 179 expense claimed = \$100,000

Expense allowed under prior law = \$25,000

MACRS depreciation allowed under prior law = $(100,000 - 25,000) \times 20\% = \$15,000$

Maine addition modification = $100,000 - 25,000 - 15,000 = \$60,000$

The Maine addition modification is based on the corporation's entire section 179 expense claimed. The Maine apportionment factor is then applied to the corporation's adjusted federal taxable income. Similarly, the corporation's recapture amounts are based on the entire \$60,000 add-back and income is apportioned after the application of the full recapture amount for that year.

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SUBJECT TO CHANGE

MACRS 1/2-year convention depreciation schedules

Recovery Year	Recovery Period					
	3-year	5-year	7-year	10-year	15-year	20-year
1	0.33330	0.20000	0.14290	0.10000	0.05000	0.03750
2	0.44450	0.32000	0.24490	0.18000	0.09500	0.07219
3	0.14810	0.19200	0.17490	0.14400	0.08550	0.06677
4	0.07410	0.11520	0.12490	0.11520	0.07700	0.06177
5		0.11520	0.08930	0.09220	0.06930	0.05713
6		0.05760	0.08920	0.07370	0.06230	0.05285
7			0.08930	0.06550	0.05900	0.04888
8			0.04460	0.06550	0.05900	0.04522
9				0.06560	0.05910	0.04462
10				0.06550	0.05900	0.04461
11				0.03280	0.05910	0.04462
12					0.05900	0.04461
13					0.05910	0.04462
14					0.05900	0.04461
15					0.05910	0.04462
16					0.02950	0.04461
17						0.04462
18						0.04461
19						0.04462
20						0.04461
21						0.02231

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